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GAO STUDIES OF FLOOD INSURANCE
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The United States Government Accountability Office (GAO) released two reports to Congressional committees within the past few days, which analyse various aspects of the National Flood Insurance program (NFIP). The studies are entitled "Flood Insurance, Implications of Changing Coverage Limits and Expanding Coverage" and "Flood insurance, More Information Needed on Subsidized Properties." These studies are part of a series of reports mandated by the Biggert-Waters Act.

Several points excerpted from the two GAO Studies on the NFIP are listed below. In all cases, the GAO language describing properties with premiums that are not "full-risk rates" is used (i.e. "subsidized") even though many do not accept that designation as accurate.

Implications of Changing Coverage Limits and Expanding Coverage

This study does not address most of the issues of interest to GNO directly, though it does note some statistics that are useful:

- There are 5.5 million policy holders in the NFIP program currently (Pg. 1);
- Insured coverage amounts to about $1.3 trillion (Pg. 1);
- Total annual premiums are $3.5 billion (Pg. 1);
- Subsidized rates represent 40-45 percent of full flood risk (Pg. 6);
- From 2002 to 2012, those residential policies with maximum coverage rose from 11 percent to 42 percent (10);
- As of September 30, 2012, 46.8 percent of residential policy holders purchased the maximum coverage of $250,000 (Pg. 10);
- The average residential claim from 2007 through 2012 was $31,020 (Pg. 10);
- Just over half of residential policies at maximum coverage were in three states – Texas, Florida and Louisiana (Pg. 11);
- Raising coverage limits would likely increase the overall NFIP risk exposure (Pg. 16);
- The financial effect, if coverage limits had been raised (from $250,000 to $417,000) between 2002 and 2011 would have been associated with increased net revenue in most years (Pg. 18);

- 2004 and 2005 would have had decreases in net revenue of $26 million and $265 million respectively (Pg. 18).

More Information Needed on Subsidized Properties

This study directly addresses many issues of interest to GNO and is highly relevant to the rate increase debate:

- Biggert–Waters eliminated subsidies immediately for about 438,000 properties (Highlights page);
- About 715,000 properties continue to have subsidies (Highlights page);
- The total subsidies will continue to decline as Biggert-Waters provisions take effect (Highlights page);
- Prior to Biggert-Waters, subsidized policies accounted for about 21 percent of all NFIP policies (Pg. 6);
- While the percentage of subsidized policies has declined since the program was established, the number of policies has remained fairly constant (at about 1 million policies) (Pgs. 6 and 7);
- Subsidized rates represent only about 40-45 percent of rates that reflect full flood risk (Pg. 6)
- Even with highly discounted rates, subsidized premiums are, on average, higher than full-risk premiums (Pg. 8);
- The study states as the reason for legislative action the fact that “Subsidies were intended to be only part of an interim solution to long-term adjustments in land use.” (Pg. 9);
- The Biggert-Waters Act eliminated subsidies on approximately 438,000 policies, and with the continuing implementation of the act, more of the subsidies on approximately 715,000 remaining policies are expected to be eliminated over time (Pg. 12);
- Of the 438,000 properties that immediately lost their qualification for subsidies, 345,000 were non-primary residences, 87,000 were business properties and 9,000 were single-family severe-repetitive loss properties (Pg. 13);
- About 92 percent of the remaining subsidized policies (after the initial Biggert-Waters eliminations) cover single-unit primary residence properties (Pg. 13);
- It is estimated Biggert-Waters will result in a decline in subsidized properties of about 14 percent per year reducing the subsidized properties by 50 percent in 5 years and in 14 years only about 100,000 will remain subsidized) (Pg. 14);
- The highest number of continuing subsidized properties are in California (64,000), Texas (44,000), Louisiana (65,000), Florida (133,000) and New York (43,000) (Pg. 17);
- From 1978 through 2011, the amount of claims on historically subsidized properties was $24.1 billion and the amount of premiums was $26.2 billion (This of course does not take account of administrative costs) (Pg. 30);
- From 1978 through 2011, the amount of claims on properties charged at the full-risk premium rate was $28.5 billion and the amount of premiums was $33.7 billion (This of course does not take account of administrative costs) (Pg. 30);

- Property elevations are unknown for 97 percent of subsidized properties (Pg. 31);
- FEMA officials said they have been using the assumption that subsidized rates are about half of the full-risk rates and are implementing premium increases of at least 100 percent for all active policies that are having their subsidies eliminated (Pg. 32);
- Without a plan to expeditiously obtain property-level elevation information, FEMA will continue to lack basic information needed to accurately determine flood risk and will continue to base full-risk rate increases for previously subsidized policies on limited estimates (Pg. 32);
- Although FEMA has information on premiums and claims paid for subsidized policies over time, it does not have the information needed to determine the appropriate premium amounts policy holders should pay to reflect the full level of risk for floods (Pg. 41).

Conclusions

Care must be taken in drawing conclusions from these studies. The calculations are complex and technical and may be affected by factors that are not apparent in relatively short-term data streams. Additionally, almost all the data is exclusive of the program's operational and other overhead costs, which are substantial.

GAO states explicitly that it is their opinion that subsidized policies are financial burden on the NFIP. On page 1 of the "More Information is Needed" report, they say, : "We have previously found that because of their relatively high losses and lower premium rates compared with policies that are charged rates intended to reflect the actual risk of flooding (full-risk rates), the policies receiving subsidized rates have been a financial burden on the NFIP."

The amount of net revenue on subsidized properties is <u>positive</u> $ 2.1 billion ($26.2-24.1), which provides 8.0 percent for administrative and other costs.

The amount of net revenue on unsubsidized properties is <u>positive</u> $ 5.2 billion ($33.7-28.5), which provides 15.4 percent for administrative and other costs.

It should be noted, however, that the subsidized policies which represent only about 20 percent of the total number of policies account for 45.8 percent of total claims.

The reference for this information is on page 30 of the "More Information is Needed" study. It is in a paragraph that is dense, convoluted and somewhat difficult to decipher, but what is stated above seems to be a correct interpretation.

This is not meant to be an indication that the subsidized policies cover all their costs or are actuarially sound.

Clearly, the unsubsidized policies provide a greater amount to cover overhead than do the subsidized policies, but not so much as to justify the premium increases being projected for the properties losing the subsidy.

Another indication that the rate increases are greater than required is that in both studies, FEMA estimates the subsidized rates already represent about half (40-45 percent in one study) of the full-risk rates. They also estimates subsidized rates would need to be approximately doubled to achieve full-risk levels ("More Information is Needed" Pg. 32). Most of the comments from GNO conference call participants indicate that a 100 percent increase is about what they expected, and that doubling of rates would not have caused the extreme concern being experienced.

The NFIP estimates of full-risk rates are also confirmed in a study be the Property Casualty Insurers Association of America. In that study, dated June 2011, they say: "We conclude that the federal government is providing overall flood insurance at one-half the true-risk cost; specifically, in high risk areas, it is providing flood insurance at one-third the true-risk costs." This estimate includes additional costs that would be needed for the private sector to offer the coverage.

Analysis based on "risks" are complex, arcane, and not necessarily intuitive. None-the-less, the level of rate increases proposed seem wildly out of line with these findings. One obvious difficult to quantify factor is adverse selection. In the "More Information is Needed" study, GAO states : "Our analysis did not adjust for potential effects on behavior(such as program participation) or changes in operating expenses that could have occurred if historical rates had not been subsidized." (Pg. 48) GAO refers multiple times to a Price Waterhouse Cooper (PwC) study from 1999 that FEMA still relies upon for some of their calculations. "The 1999 PwC study estimated that, for communities most likely to experience a decrease in property values if subsidies were immediately eliminated, on average, 50 percent of policy holders might cancel coverage." (Pg. 34)

The large rate increases proposed are particularly disturbing given the GAO comments about FEMA's lack of reliable information on which to base their proposed rate increases. Making extreme rate adjustments without adequate basis is not appropriate ever, but especially not when it could have devastating impact on substantial numbers of home-owners and communities.